MORSE ASSET MANAGEMENT, INC.
23 Old Kings Highway South, Suite 200, Darien, CT 06820

April 17th, 2023

2023 Q1 Investment Commentary

The U.S. equity markets began the year on a positive note, rallying on the back of improvements in inflation, GDP, earnings better than feared, continued labor market strength, and consumer resilience. However, there was no shortage of drama and markets remained uncertain. A higher-than-expected inflation reading and a massive jobs number surprised markets, reigniting fears the Federal Reserve would be forced to push rates higher for longer. Negativity was compounded by two bank failures in March. Subsequent data points have been positive, reaffirming that both the Fed's "medicine" is working and that the banking crisis was contained. As inflation continues to trend lower, economic and consumer activity is slowing, and the job market growth is finally waning, but a recession is not imminent. Markets again found their footing and have since rallied back, currently near highs for the year.

Despite recent signs of improvement, the outlook remains fragile and downside risks are elevated. Inflation remains well above target and could persist. There is no end in sight for the war in Ukraine. Trade tensions, especially around China, are high and could worsen. Concerns about financial vulnerabilities have risen, especially in banks and the housing markets. Economists, including the Fed Staff, are forecasting a recession. Sentiment and institutional positioning are overly bearish. Equity prices, however, are diverging from the consensus narrative as positive facts and data are reflecting optimism. Bullish macroeconomic or earnings reports will likely result in another round of buying. This sets the market up to move higher, climbing the proverbial wall of worry.

Leadership has reversed in 2023 and is consistent with a cyclical bull market. Stocks outperformed bonds. Growth outperformed Value. Technology was the best performing sector, up +21.8%. Energy, following its best year relative to S&P 500, was the worst performing sector, off -4.7%. Large caps outperformed small. Commodities and the dollar fell. Market breadth has started to improve.

The U.S. banking system is sound and resilient. The coordinated measures taken by the Fed, the Treasury, and the FDIC in response to the two bank failures in March, likely idiosyncratic (crypto, venture capital concentrations), have prevented an escalating liquidity crisis. However, this development will result in tighter credit conditions for households and businesses and weigh on economic activity as banks struggle with profitability due to rapid interest rate hikes. The extent of these effects is uncertain, but it is estimated to likely be a 0.50% additional increase in rates. This contributes to the risk of recession over the next 12 months.

The March Consumer Price Index and Producer Price Index inflation reports showed inflation pressures continuing to pull back. CPI eased to 5.0% y/y from 6.0% y/y in the prior month and the peak of over 9% in June of last year. PPI for final demand came down even more to 2.8% y/y from 5.0% in the prior month. Both trends continue to show we are heading in the right direction. Further, PPI declining faster than CPI should also take some pressure off corporate margins, which have been pressured earnings by rising wages and borrowing cost.

Persistent labor market strength that has characterized the post-pandemic recovery and expansion has begun to wane at a manageable pace. The U.S. economy created 236K net jobs in March, the least since December of 2020. Less jobs were created; however, the unemployment rate fell to 3.5%. This was due to an expansion both in the number of persons employed and the size of the labor force as those re-entering the workforce are finding jobs. Last week's Initial Jobless claims continued to rise slowly to 239k and job openings continued to decline. These trends are positive considering their expected impacts on inflation as long as the pace does accelerate.

The ISM Manufacturing PMI decreased to 46.3 in March of 2023, implying that rising interest rates and growing recession fears are weighing on businesses. The ISM Services PMI fell to 51.2 but is still expansionary. Despite the implied slow down, U.S. GDP grew at a +2.6% rate over the last three months of 2022. The resilient labor market and consumer continues to keep Q1 GDP estimates positive (Chart).

While consumer sentiment is still far below its pre-pandemic level, it has picked up since the lows last summer as inflation improves (Chart). The University of Michigan consumer sentiment unexpectedly increased in April, beating forecasts. Total consumer spending rose 1%, reflecting strength in Services, but retail sales were down 1% month-over-month. Additionally, the personal saving rate picked up to 4.6% from 4.4% in the prior month, the highest level in over a year, but is still well below its long-term average. Building permits in the US reflected the highest reading in five months. CEOs are also still cautious, but pessimism has begun to wane.

The Fed is expected to raise rates 0.25% at their next meeting in May, bringing the target rate range to 5-5.25% and in-line with the average members targets for 2023 of 5.13%. Members have continued to support a hawkish narrative or "higher for longer" despite clear improvements in inflation, an economic slowdown, and the recent bank failures. Market expectations continue to see the Fed cutting rates this year, but the divergence has recently narrowed following containment of the bank crisis.

Money Supply in the United States continues to decrease as the Fed runs off its balance sheet. In addition, tighter lending is restricting liquidity and is a headwind for equities. This has been reflected in markets with rotation back and forth between asset classes and equity sectors because there is not enough money in the system. The Inflation Reduction Act and cost of living adjustments to Social Security will provide a meaningful uptick in federal payments this year. This Fiscal spending will be stimulative.

The aggressive reset of earnings estimates we saw in Q4 has continued into 2023 (Chart). According to Factset's April 14th *Earnings Insight*, the Q1 2023 year/year earnings for the S&P 500 are estimated to be -6.5%, down from -0.6% at year end. This will mark the second straight quarter of declining earnings. The decline in estimates is primarily attributed to contracting margins as revenue continues to growth. Expectations continue to favor a return to growth in the back half of the year with earnings +0.9% for 2023 (Chart). The 12-month bottom-up target price for the S&P 500 has risen to 4,619.32, which is 11.4% above current levels. Valuations have followed the market higher but remain between the 5- and 10-year average.

Our playbook continues to focus on significant secular, cyclical, and structural trends. We will continue balancing between high-quality growth at reasonable prices and stable businesses with relatively stable free cashflow. Portfolio risk will be adjusted according to the prevailing market environment and the shifting likelihood of recession.

Markets are discounting the current earnings decline and slowing economy and are looking forward. We are watching the ramifications of the banking crisis closely, but the market has already looked past, regaining levels reached before the bank failures. Forecasts may be negative, but facts and hard data are more optimistic. This push and pull of positive and negative will likely keep the market rangebound until the Fed pause their interest rate hikes, but we are encouraged by performance year to date. Patience and conviction will be rewarded.

Morse Asset Management Investment Team

Robert B. Morse, Jian Wang, James Cushing

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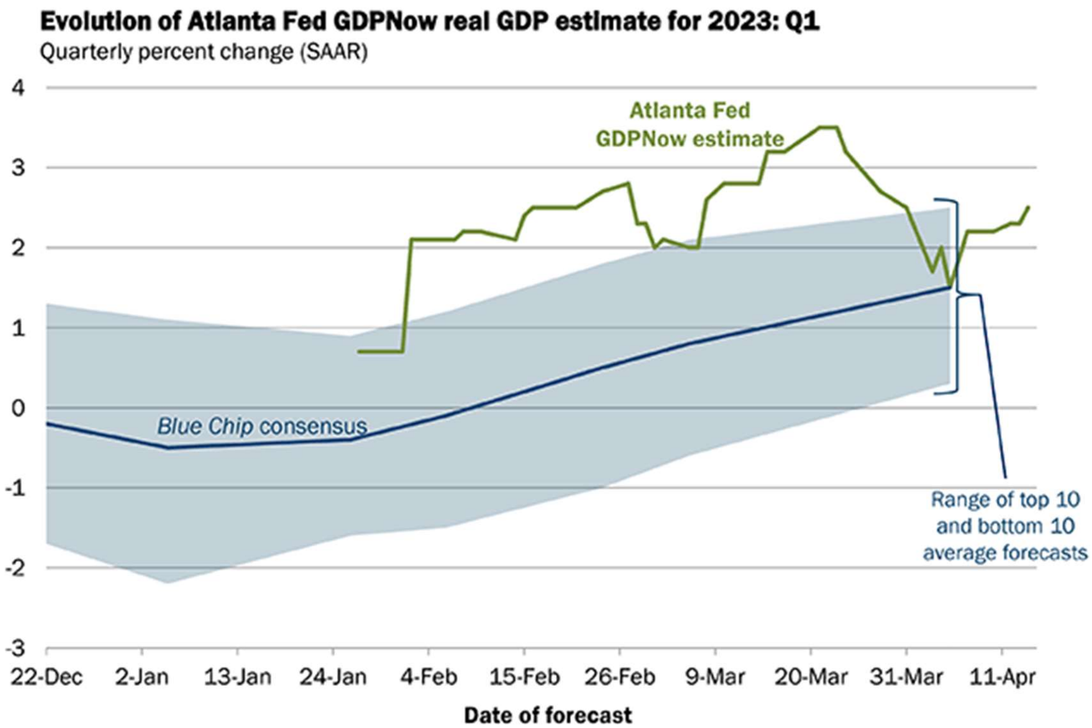

Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

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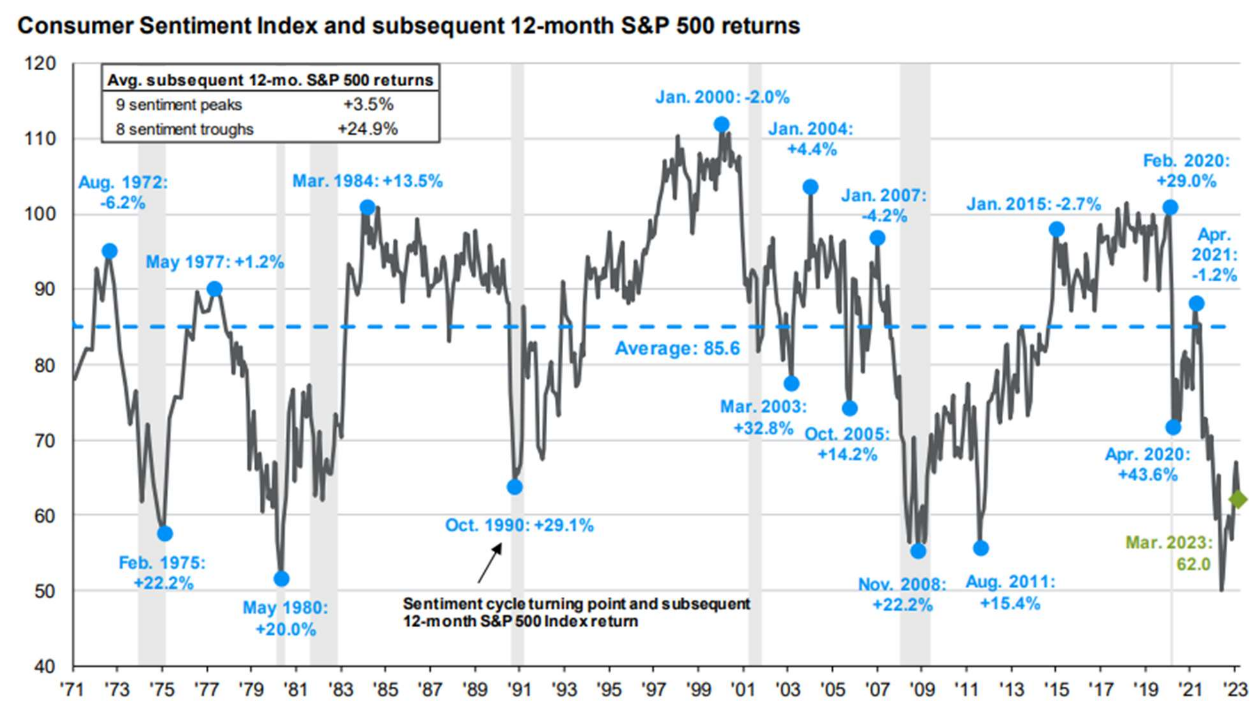

Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management.

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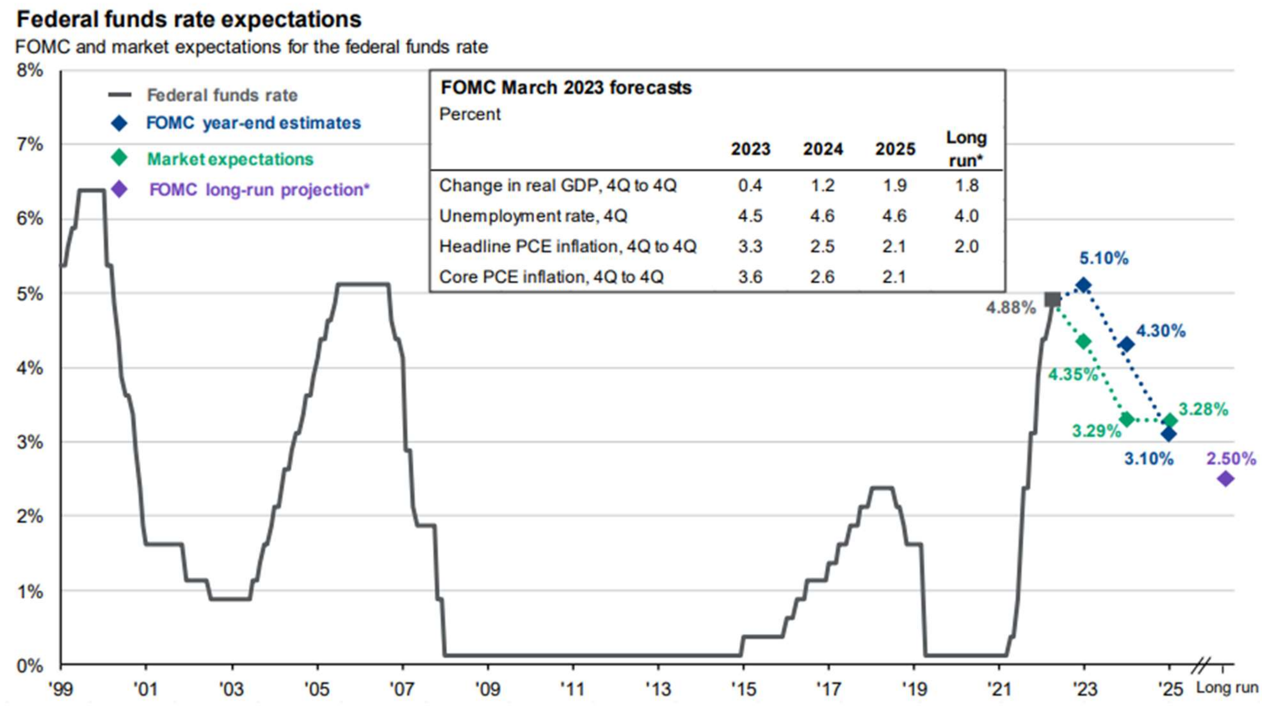

Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.

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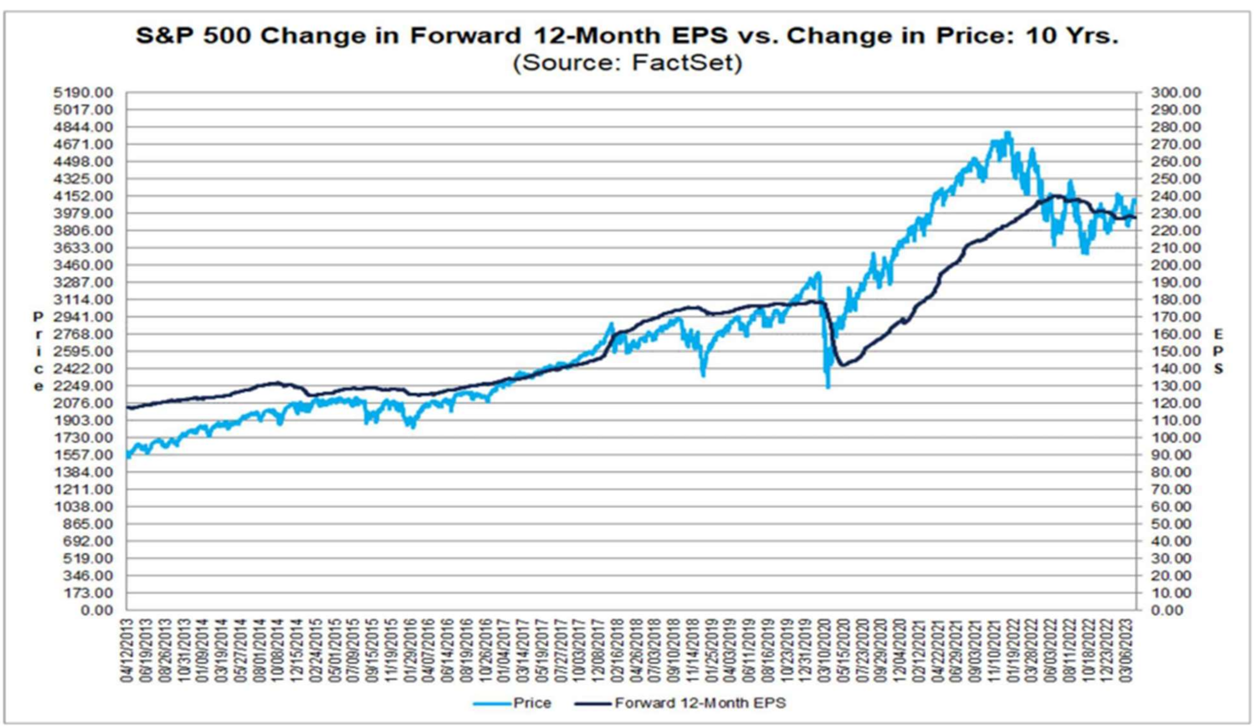

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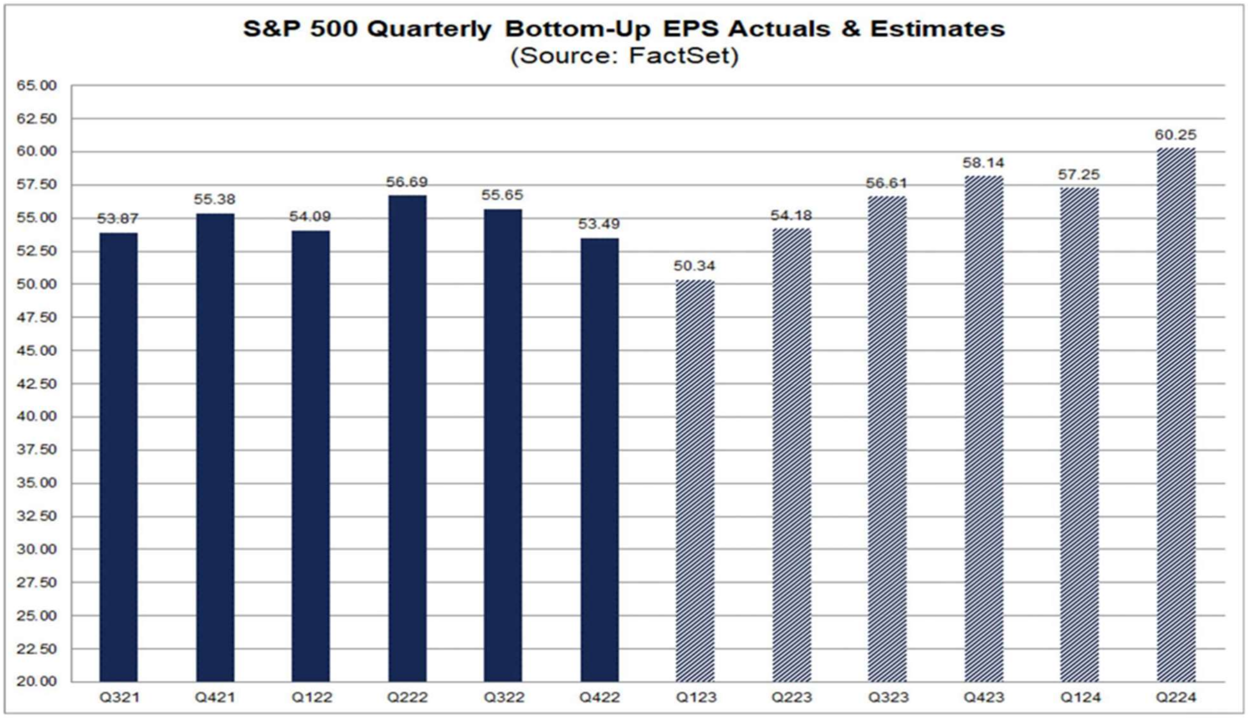
S&P 500 Quarterly Bottom-Up EPS Actuals & Estimates
(Source: FactSet)
65.00
62.50
60.00
57.50
55.00
52.50
50.00
47.50
45.00
42.50
40.00
37.50
35.00
32.50
30.00
27.50
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